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Factoring:

The devil is in the details

Adrian Isaacs recently wrote an article titled: "Factoring: What is it and how does it work?" In this related article, he discusses many of the common terms and conditions when considering factor financing.

> As with all kinds of financing solutions, there are always fine print terms and conditions, which vary widely amongst the many factor financing companies in Canada. Understanding the fine print can save you thousands of dollars and significant time.

As a brief recap, when you invoice your customers, a lender (let's call them "Factor Co.") will give you the money today and they will wait the 60, 90 or 120 days for your customer's payment. You pay Factor Co. interest from the date you get the financing to the date that Factor Co. receives payment from your customers.

For clarity, the typical fine print terms and conditions of factoring have been grouped into three sections: Factoring Terminology, Fees & Costs, and Legal Considerations.

A. Factoring Terminology:

Sales Invoice Eligibility

Typically sales invoices that are under 90 days are considered eligible for consideration by factor financing companies. Some will extend beyond this type of eligibility, but it's largely driven by the credit strength of your customer.

Advance Rate

This is the actual amount of money you will receive when you factor an invoice. The advance rate varies between 75-90 percent of the invoice and depends on a few considerations such as whether your business insures their accounts receivable or if your customers are established blue chip companies.

Hold Back

The hold back is the remaining 10-25 percent which the factor will remit to you (net of any fees or adjustments) once they receive payment from your customer.

Notification vs. Non-notification

The majority of factoring is done on a notification basis, which means that a factor advises your customer of the factor arrangement and instructs them that the sales invoice should be remitted directly to the factor. Some factors offer factoring on a non-notification basis (sometimes called Invoice Discounting). In this scenario, customers are unaware of the factor arrangement and they continue to pay you directly. This option requires the borrower to assume additional costs to set up a customized bank account (generally called a Blocked Account).

Recourse or Non-recourse Factoring

Factoring with insurance that protects the borrower is called non-recourse factoring. If your customer defaults on payment, you can claim the loss from your insurance company.

Term

Most factors require a 12-month term and include a penalty for early termination. A few offer month-to-month solutions with the ability to terminate on 30-days notice.

> The majority of factoring is done on a recourse basis, meaning that if your customer does not pay, you are liable to the factor for the amount you initially received for the factored invoice.

B. Fees and Costs:

Interest Rate

The interest rate (also known as the Discount Fee or Discount Rate) is the rate at which interest is paid by a borrower. These rates typically vary from 1.5 percent per month to more than 4 percent per month.

If you commit to a 12-month term, some factors will offer you a lower interest rate.

Plus it's important to note that interest is applied to the Face Value of the invoice (which includes sales taxes) but factors generally only lend between 75-90 percent (Advance Rate) of the face value. So the effective interest rate cost is marginally higher than the quoted rate.

Factors often quote their interest rate in different ways, some of which include: prime plus, daily, monthly or cost per hundred (i.e. the cost you would pay for every hundred dollars financed). In order to ensure an "apples to apples" comparison, one needs to carefully understand the rates you are comparing between different factors.

Minimum Monthly Interest Charges

Most factors charge a minimum monthly interest charge, which is the minimum amount you have to pay for a given month. It's charged regardless of whether you use the facility.

Initial Loan Application Fees

The majority of factors charge a one-time non-refundable fee, which varies in amount, depending in the size of the factoring facility.

Legal Fees & Disbursements

Factors require the borrower to pay all legal fees incurred during the loan application process. Some factors offer in-house legal services while others use law firms to assist. It is important to understand how these fees are incurred, and the range, which can vary from $500 to $10,000 depending on the size and complexity of the factoring transaction.

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C. Legal Implications:

Collateral or Security

All factors require a first charge or lien on the sales invoice which forms part of the accounts receivable. Often, the fine print in a contract extends the lien beyond the receivables to all of the other business assets.

Inter-Creditor Agreement

In most cases, factors will fund most, if not all of your sales invoices. In some situations, factors may only factor a few customers and work in conjunction with your regular bank. This scenario requires the two lenders to enter into an Inter–Creditor Agreement which will add an additional cost.

Documentation

These generally include the Factor Loan Agreement, a general security agreement (commonly called a GSA) which provides the factor with a lien on the business assets. Other documents required could include: various corporate resolutions, minutes, directions and guarantees from related parties where applicable.

Personal Guarantee

Most factors require the personal guarantee of the business owner. This does not typically include a collateral mortgage on your home, unless you need more financing in which case some factors may over advance against this type of collateral.

As you can see, there are many issues to consider when making this decision. Our Financing Advisors can help you navigate the process to make it less daunting and help you select a cost-effective factoring solution for your business.

Isaacs Advisory are experts at sourcing financing solutions for small to medium-sized businesses with financing needs of $100K to $1Million. We work with a wide array of traditional and non-traditional lenders across Canada to source and structure financing solutions to meet our clients unique financing. For more information, please contact Adrian Isaacs at (416) 835-4511 or aisaacs@isaacsadvisory.ca.